



DEPARTMENT OF JUSTICE

ANTITRUST CONSIDERATIONS IN INTERNATIONAL DEFENSE MERGERS

Address by

ROBERT KRAMER
Chief, Litigation II Section
Antitrust Division
U.S. Department of Justice

Before the

American Institute of Aeronautics and Astronautics

Arlington, Virginia

May 4, 1999

Introduction

Thank you for the opportunity to discuss antitrust considerations in international defense mergers.¹ The Antitrust Division has, over the past several years, been an active player in defense industry consolidation along with our sister agency, the Federal Trade Commission. The Division will remain active, reviewing both domestic and international defense mergers that affect the United States. The review will be based on the guiding principle that competition is vitally important in all markets, including defense markets. Let me briefly review with you our actions to date, review our most frequent competitive concerns in defense mergers, and discuss how globalization may impact our response to mergers, domestic and international.

Defense Activity

While the merger wave of the 1990s has been broad, in certain key sectors of our economy, it has included a substantial number of the major firms. In defense, declining demand and the resulting overcapacity triggered U.S. consolidation. The large majority of these mergers proceeded unchallenged. In the past few years, as the industry has become more consolidated, we have been increasingly active to ensure that rationalization does not harm competition.

Thus, in the past two cases, we challenged four mergers in the defense industry due to competitive concerns. We have been active in reviewing teaming arrangements and recently assisted the Department of Defense in their reviews of shipyard mergers. In 1997, Raytheon acquisitions led to two defense industry consent decrees: one concerned the acquisition of the defense electronics division of Texas Instruments, and the other concerned the acquisition of General Motors' Hughes Aircraft subsidiary. Last year, we sued to enjoin the proposed merger between Lockheed Martin

¹ The views expressed in this paper are my own and do not necessarily reflect the views of the Antitrust Division.

and Northrop Grumman. Working closely with the Department of Defense, we concluded that if the proposed merger were allowed to proceed, the U.S. military would suffer a substantial loss of competition and innovation for a number of critical weapon systems and components. The proposed \$11.6 billion acquisition was the single largest transaction ever challenged by federal antitrust authorities. At around the same time, we also reached a consent decree related to L3's acquisition of Allied Signal's towed array sonar business and also investigated teaming arrangements on the DD-21 class of destroyers. Most recently, we assisted Steve Grundman's staff in their review of shipyard mergers that culminated in Secretary Cohen's decision not to support the proposed General Dynamics/Newport News merger.

Let me use these cases to illustrate the issues we will be concerned with in any defense merger. First, is the traditional antitrust concern over the loss of price and cost competition between the merging parties. This competition can take many forms, from all or nothing downselects for the award of programs to continuous dual-source competition for mature systems. Study after study shows savings to the government from both winner-take-all production competition and from dual-source continuous competition--such as the benefits to the government from the GE/Pratt & Whitney engine wars on the F-15. The last two years, our reviews have focused on a number of instances when the military has benefitted from this direct price competition, ranging from the SQQ-89 sonar system to the AMRAAM missile. When the number of players becomes small, the price impact of a merger on upcoming programs and bids will be a major focus of our concern.

In some cases, we have insisted on divestitures to protect ongoing competition, such as in armored vehicle electro-optical systems in the Raytheon acquisition of Hughes Aircraft.

The most interesting twist probably involved the AMRAAM. Studies of bidding on the dual-

sourced AMRAAM clearly showed substantial cost reductions as a result of bidding between Hughes and Raytheon. There was convincing evidence, however, that expected purchases under this program had dropped so far that costs would actually increase without the merger--essentially that scale economies were starting to outweigh the benefits of continued competition. There was also a long track record that made the Air Force comfortable with what cost curves on the program should look like. In these unique circumstances, we held up the merger until Raytheon reached a firm pricing agreement with the Air Force to guarantee that \$180 million in consolidation savings were passed on to the Government.

As important as price competition is to us, a second major and possibly even greater concern is maintaining competition for innovation. A cornerstone of the Government's antitrust challenge to the Lockheed-Martin / Northrop-Grumman merger was concern that the acquisition would have substantially lessened competition with respect to innovation in the development of various technologies and defense programs.

Unlike the challenge that sometimes faces us in other cases, it was easy to articulate the ways in which a decline in innovation could have an adverse effect. When our defense strategy depends on maintaining a technological lead over possible adversaries, as the Attorney General indicated when the case was filed, reduction in the pace of innovation can have life-and-death implications.

The products implicated by the transaction were on the cutting edge of high technology: high performance military aircraft, infrared and radio frequency electronic warfare countermeasures, airborne early-warning radar systems and fire control radar.

We found support in the general economic literature that the *number* of innovators is critical in the development of breakthrough technologies. Furthermore, in studies such as those of Mark

Lorell at RAND, we found concrete examples of the applicability of this literature to military markets. Although incremental advances usually come from incumbent firms, pathbreaking technological breakthroughs have often been made by second tier producers and firms that have recently lost major competitions. One of the concerns that the Government had about the acquisition of Northrop Grumman was that the elimination of an innovative smaller competitor would lower incentives to push pathbreaking technologies, such as in the area of unmanned combat vehicles. Firms with much at stake in the status quo are less likely to push paradigm shifting new alternatives.

We ultimately concluded that one competitor was not enough and that even in markets characterized by lumpy purchases and high research-and-development expenditures, two competitors were not necessarily sufficient to assure the kinds of innovation that only an open and robustly competitive market structure was likely to generate. Similar concerns were at play in the General Dynamics/Newport News review where Secretary Cohen's press release noted how the merger would concentrate engineering talent and R&D funding under one roof. I should emphasize that our concern over lost innovation, has been the basis for challenges to a number of non-defense mergers as well.

A third major concern of ours in defense mergers is that mergers of dominant firms in critical technologies can lead not only to higher prices, but that when these essential components and subsystems are discriminators in the bid evaluation process they may be withheld from competitors (or given only at disadvantageous terms) to foreclose broader system competition. This was precisely our concern when Raytheon proposed to acquire the high power amplifier MMIC business of Texas Instruments. We found that because of the importance of x-band high power amplifier MMICs to modern active electronically scanned array radars, that MMICs would be important

discriminators in awarding radar systems. Raytheon had produced more high power amplifier MMICs than any other firm and Texas Instruments was a recognized leader in the field. The two firms were, we concluded, the *only* firms capable of producing MMICs for over \$10 billion in upcoming radar competitions. The resulting monopoly would have had significant ability to raise prices for MMICs. More importantly, however, we believe that the merger as originally proposed would have resulted in significantly lessened competition for military radar through the control Raytheon would have gained over the critical input.

Similarly, in our review of Raytheon's acquisition of Hughes Aircraft, we concluded that the combination of businesses making large staring focal plane arrays (FPAs) would likely not only lead to higher prices, but could disadvantage competitors in upcoming systems competitions. In each of these mergers, the analysis was based on an examination of the relevant technology, the capabilities of alternative sources and the impact on discrete programs.

This concern about foreclosure goes beyond mergers and was our focus in a nonmerger investigation into exclusive teaming arrangements for the DD-21. Ultimately, Dr. Gansler rejected the original teaming arrangement, a decision that permitted the formation of two competitive teams, creating design competition for ships and competition between electronics integrators. Specifically, we were concerned that the combination of the two shipyards likely to realistically win the contract--Ingalls and Bath-- with a single electronics integrator would preclude competition in both shipbuilding and electronic integration. In other cases as well, the Department of Defense, to maintain competition, has had to break up exclusive teaming agreements that have "captured" a critical input. As a result of that experience, Dr. Gansler on January 9, 1999, warned the military departments to be aware of and guard against anticompetitive teaming arrangements.

We have reviewed a number of other possible vertical concerns from defense mergers. One that is of particular concern, is that economic incentives will push vertically integrated prime contractors to use in-house systems, unless an independent system gives a clear and critical advantage. As the Defense Science Board reported: “Gaining new internal sources of supply may cause a parent firm to favor the internal source over external suppliers, even if external suppliers are superior. This can not only weaken supplier-level competition but result in inferior defense products.” I would add that this problem is increasingly difficult to monitor as Defense Department procurement staffing is downsized.

Another type of vertical concern was raised by L3's acquisition of Allied Signal's Ocean Systems Division, a leading designer and producer of towed arrays. Allied Signal's principal competitor in the towed array business was not L3 but Lockheed Martin. L3 did not make towed arrays at all, so post-merger there remained two competitors. Lockheed Martin controlled seats on the L3 board of directors, however, as a result of its minority interest. We were concerned that the acquisition could result in the two leading providers of towed arrays to the Department of Defense having access to each other's business plans, costs, pricing data and decisions, and other internal competitively sensitive information and that such access could significantly decrease incentives to compete vigorously. To solve the problem in very unique circumstances, the consent decree created a firewall that prohibited L3 from making any nonpublic information concerning towed arrays available to any member of L3's board of directors nominated or connected to Lockheed.

International Mergers

I have catalogued these challenges and concerns not to open old wounds or to debate past decisions, but to make it clear that we will also be reviewing international defense mergers. We are currently reviewing, for example, the British Aerospace acquisition of GEC Marconi. In doing our review, our substantive concerns will remain the same and will need to be addressed.

Traditionally, mergers among foreign defense firms or between U.S. and foreign firms did not create a blip on our radar screen. The Clayton Act (our principal merger statute) protects United States consumers, including the Department of Defense, from lessened competition in any section of the country. The law does not make actionable anticompetitive outcomes that will hurt only consumers or governments abroad. Furthermore, the Pentagon seldom bought from foreign sources, especially cutting edge technologies. Although the defense business was global, the market of concern was national.

Antitrust law requires enforcers and courts to define geographic markets. When we define markets we identify the production locations customers would turn to in the event of anticompetitive conduct. For years, with the U.S. military unwilling to rely on foreign suppliers, the market was defined as the United States. That is how it has been defined in every complaint that we have filed in court.

Today we are at one of those points of time when long-term assumptions are being questioned. With the globalization of the United States economy, some markets once considered national in scope have become global. More frequently, the Defense Department is considering and using foreign firms, particularly as teaming partners. The internationalization of defense procurement, however slow and incomplete, will necessarily affect how we review mergers. This

is because the definition of geographic markets is not static. Market definition is based on consumer preferences and needs; and as customer preferences change, so does geographic market definition.

On a case-by-case basis and a product-by-product basis we will be asking the Pentagon what firms it views as good *and* otherwise acceptable substitutes for the merging firms. In some cases, in fact in most cases, for the foreseeable future, the answer may remain--the United States military will likely *only* rely on United States firms, especially for advanced technology products. In other cases, the list of players in the market may be broader. For some products the number of acceptable substitutes may be limited to firms in one country; for other products the Pentagon may be willing to turn to a number of firms in different countries. The answer will depend on *both* security issues and the technological competencies of foreign firms. But the determination will be intensely fact driven. And the answer to that question will be critical to deals and merger analysis. If for example, after careful review, the Pentagon found that certain foreign firms were technologically capable of supplying the U.S. military and were otherwise acceptable alternatives (given trade and security issues), they would be considered in the market.

When trans-border deals arise, businesses can expect that federal antitrust enforcers will be involved. Deals most likely to raise competitive issues will almost certainly be subject to the reporting requirements of Section 7a of the Clayton Act, also known as the Hart-Scott-Rodino Act. The act imposes Premerger reporting requirements and waiting periods on mergers that meet the threshold requirements concerning contacts with the United States, threshold that large transborder deals are likely to exceed.

Cooperative Investigations

After you make a Premerger notification filing, you can expect that Antitrust Division staff and staff from Steve Grundman's shop and from OSD's General Counsel's Office will work closely to review it. When the Antitrust Division learns about a transaction we contact General Counsel's Office as part of an initial review and we do not terminate that initial review until the Department of Defense signs off on it. When a more detailed investigation is justified, the two agencies jointly investigate it. During Lockheed Martin-Northrop Grumman, the broadest investigation to date, the staff of the two agencies worked in joint product teams to cover each major area involved: aircraft, naval systems, radar and electronic warfare. The staffs routinely achieve a high degree of consensus, a consensus built on repeated working relationships, the sharing of information and open dialogue. The staffs of each agency, of course, make their separate recommendation up the chain of command. And, ultimately the litigation decision rests with the Attorney General, a decision that is reached after careful coordination with the Secretary.

The cooperation between antitrust and the OSD staffs likely assures that the United States government will speak with one voice on defense mergers. But what about consensus among competition authorities in other countries? Because we likely will see transactions that may affect competition in more than one country or continent and because of the increasing importance of antitrust in many countries around the world, it is not surprising that we increasingly are reviewing transactions that are also being considered by foreign competition authorities.

In mentioning this, of course, we probably all remember the concerns that arose two summers ago when the Federal Trade Commission and the DG IV of the Commission of the European Communities reached different conclusions with respect to the Boeing/McDonnell-Douglas merger. While that kind of divergence is unique in our experience, the enforcement agencies have been

exploring ways to avoid any recurrence and, to that end, we and the FTC have been working closely with DG IV.

In recent years, we have had the most frequent need for pre-merger review cooperation with the EU. In reviews of the defense - aerospace industries, *who* we will deal with is complicated by the ability of EU member states under Article 223 of the Treaty of Rome to reserve defense matters to themselves. If products have dual-use, we might even see reviews both by the EU and member states. I can tell you, however, from my most recent experience that enforcement cooperation *can* work very well.

Less than two weeks ago, my office finished its review of the Imetal tender offer for English Chine Clay which we coordinated with DG-IV and with Canadian authorities. I can tell you that from the trenches, this coordination means frequent contact with our counterparts in Europe, and full discussion of the competitive effects of mergers and of possible settlements. These independent but coordinated investigations culminated in a proposed U.S. consent decree. In this matter, Division and DG-IV staffs shared views and information about the transaction, pursuant to written waivers of confidentiality by the parties; and, again, the Commission and Canadian authorities relied on Imetal's consent decree with the divestiture commitment to the Division to resolve competitive issues.

Cases like this illustrate how well-coordinated merger enforcement should work. Our staffs interacted frequently and effectively; the merging parties were able to work through issues with both staffs at roughly the same time; all sovereign entities preserved independent decision-making authority; and the divestiture results satisfied the competition concerns of the U.S., Canada and the EU. We will continue to work with the EU along these lines, and with other antitrust agencies as

well, in appropriate circumstances, while maintaining our independent authority to enforce U.S. antitrust laws.

To summarize my points, first let me say that products and capabilities of foreign firms will be important to our consideration of international mergers, to the extent that the Department of Defense considers the foreign firms that make them to be real options. To the extent that the United States' military's reliance on foreign firms increases, our market definition will broaden. Second, you can expect an active United States review to make sure that trans-border mergers do not substantially lessen competition in the United States. During that review, you can expect the antitrust agencies to coordinate closely with the Department of Defense to reach a consensus. Finally, you can expect the antitrust agencies, as appropriate, to coordinate with other competition authorities to try to reach an international consensus as well.